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C O N F I D E N T I A L SECTION 01 OF 03 ANKARA 000136

SIPDIS

STATE FOR E, EB/IFD AND EUR/SE
TREASURY FOR OASIA - LOEVINGER, MILLS AND LEICHTER
NSC FOR MCKIBBEN AND BRYZA
STATE PASS USTR FOR NOVELLI/ERRION

E.O. 12958: DECL: 01/05/2013
TAGS: EFIN EINV PGOV ETRD TU
SUBJECT: TURKEY'S ECONOMY: WHY WE NEED TO KEEP UP THE PRESSURE FOR REFORM

(U) Classified by Charge d'Affaires Robert Deutsch. Reasons: 1.5, (b,d)

¶1. (C) Summary: Government leaders are celebrating a successful economic year, with inflation dropping to 18.4 percent, growth near the 5 percent target, and interest rates on the massive public debt falling dramatically. The sense of crisis has faded. The AK Government deserves some credit for progress, as it learned from early mistakes, stuck to tight fiscal policy, and completed, albeit slowly, key IMF reviews. External factors -- the rapid conclusion of our Iraq operation, a global surge in demand for emerging market assets, and the U.S. assistance offer -- also were critical to this year's success, as was the Turkish lira's unexpected strength. Despite progress, the economy is not out of the woods. Public debt remains dangerously high, the current account deficit is large and growing, and any significant scare -- whether due to lack of reform, failure to make progress with the EU, or a political or external shock -- could send the lira tumbling and the economy back toward crisis.

¶2. (C) At the political level, an absence of understanding and commitment to the structural reforms that are essential to the sustained growth Turkey needs remains. In 2003, privatization again failed, there was no movement on developing energy markets, independent regulatory boards were weakened, and there was no measurable progress in dealing with corruption and rule of law, or in resolving trade and investment problems. The government has an opportunity in 2004 to push the economy further away from crisis and toward sustained growth; however, it is unlikely to do so without strong international pressure. The IMF will provide pressure on narrow fiscal/financial issues, but with little focus on structural reform. The World Bank is more willing to condition its loans on structural reform implementation, but has less leverage and needs G-8 support. The economic conditionality in our financial agreement could be effective leverage to ensure Turkey goes beyond its narrow IMF mandate and implements the structural reforms that are needed. We also need to push hard on our trade and investment issues. End Summary.

¶3. (SBU) Turks celebrating the New Year have forgotten how dire their country's economic situation looked nine months earlier, when the lira was rapidly weakening, interest rates on government t-bills hit 77 percent, and market analysts wondered aloud whether the Treasury would be able to borrow enough money to make domestic debt payments in April. The year ended with inflation at 18.4 percent, growth at or above its 5 percent target, the public debt/GNP figure dropping from 78 to near 70 percent, and exports up nearly one-third. The lira appreciated from TL 1.75 million/dollar in late March to TL 1.4 million/dollar, and yields on government securities fell to just over 25 percent. The main stock index closed the year up nearly 80 percent. More broadly, the sense of crisis that had pervaded economic discussions since late 2000 faded, to the point that Treasury's announcement of $11 billion in domestic debt redemptions in January barely caused a ripple.

¶4. (C) AK Government leaders claimed full credit for this success, and in fact deserve some of it. After a bad start, the government followed the IMF's prescription and minimized populist pronouncements. It took the fiscal steps needed to come close to -- if not reach -- the 6.5 percent primary surplus target, and it completed, albeit with delays, key IMF program reviews. Conversations with the business community and financial markets suggest that confidence in the government's economic management grew during the year.

¶5. (C) On the other hand, many analysts argue that much of

2003's economic success was due to developments outside of the government's control. The rapid end of the Iraq war, combined with the sharp increase in Turkish exports to post-war Iraq, made the operation a boon to the Turkish economy, rather than a cost. The turning point in the financial markets was the USG's announcement of an $8.5 billion financial assistance package. Even though Turkey has yet to draw from that money, the announcement alone caused interest rates on government t-bills to fall 9 percentage points in 48 hours, kicking off a rally that continues to this day. That rally has been fed by the global flow of funds to emerging markets and substantial reverse currency substitution (i.e., Turks trading their foreign exchange holdings for lira). The unexpected strength of the lira has helped disinflation efforts, reduced the public debt/GNP ratio, and -- because of its enormous psychological import to Turks -- generally increased confidence.

¶6. (C) These developments have given Turkish leaders an exaggerated sense of their economic policy prowess and disguised the economy's underlying vulnerabilities. Few in Turkey's leadership understand even now that the economy is far from being out of the woods. The debt/GNP ratio remains dangerously high (with much of 2003's decline due to the lira's strength), external debt has increased significantly, the current account deficit is large and rising, inflation has not yet been defeated, the banking sector remains weak and vulnerable (if stronger than it was 1-2 years ago), and there are serious questions about the sustainability of export growth if the lira remains strong. (There are also the longer-term problems of excessively-high tax rates, a narrow tax base, and a huge informal economy.) Particularly in the context of a growing current account deficit, anything that significantly affects market confidence -- a failure to implement reforms, a lack of progress on Cyprus/EU accession, a public perception that the U.S. $8.5 billion (and a perceived continuing level of U.S. support) might not be forthcoming, or some other political or external shock -- has the potential to send the lira tumbling, interest rates soaring, and to return the economy to crisis or near-crisis mode.

¶7. (C) The government has an opportunity in 2004 to reduce the economy's vulnerability further and to take another large step toward the sustained, low-inflation growth that Turkey needs to get out from under its debt overhang and create jobs. To achieve this, it needs to take the right political steps on Cyprus/EU and to maintain good relations with the United States. Economically, it needs to avoid populist temptations -- the recent decision to raise the minimum wage 34 percent and pensions 21 percent is a flashing warning light in the run up to March municipal elections -- and improve the quality of its fiscal adjustment, which so far has been based too heavily on tax increases and not enough on spending cuts. The government also must go beyond its tepid implementation of the narrow range of IMF-mandated policies to pursue the full menu of structural reforms that are the key to attracting investment and unlocking the country's growth potential. Unfortunately, the government in 2003 did a poor job of implementing those reforms. For example:

-- Although the GOT convinced nearly everyone that it was serious about privatization, 2003 was another year of failure in this area. The government canceled the Tekel tobacco privatization (price was too low), delayed the Tupras privatization, and did not implement the Petkim privatization (wrong buyer). It ended the year with privatization sales worth less than $900 million (actual proceeds were less), when it easily could have achieved results in the $2.5-3 billion range. The main problem was that the government got hung up about valuations, and failed to understand that the real reason to privatize is to create efficiency, not raise revenues.

-- The GOT made no progress on developing the critical energy market. For political reasons, the Prime Minister refused to approve a shift to a regional tariff structure, an essential part of creating a cost-based market. The GOT also did not to raise prices in line with inflation/costs, failed to honor its commitment to begin transferring natural gas import contracts from BOTAS to the private sector, and harassed existing BOT electricity producers in a misguided effort to force them to lower prices.

-- The GOT failed to support -- and arguably weakened -- independent regulatory boards, the creation of which was a critical step in the 2001-2002 reform process. It forced BRSA Chairman Akcakoca to resign; this would have been acceptable, given BRSA's failure to catch the Imar Bank fraud, had not the GOT made clear from the beginning that it wanted to control the agency. It also failed to support the

Energy Market Regulatory Agency, which by law is supposed to set prices, instead allowing the Energy Ministry to maintain authority over this and other critical energy market issues.

-- Despite a legal requirement to implement telecom liberalization as of January 1, 2004, the Telecom Authority still has not issued implementing regulations. Moreover, industry analysts say the Authority does not have the expertise and clout to regulate the market effectively.

-- There was no measurable progress in addressing corruption and rule of law issues (albeit these are long-term projects), and virtually no discussion within the government about how to promote competition and productivity.

-- The government did virtually nothing to resolve our foreign investment disputes and problems or to eliminate WTO-inconsistent market access barriers. Although these issues are not highlighted in either the IMF or World Bank programs, they have a direct impact on Turkey's ability to attract investment and develop a market-based, competitive economy.

¶8. (C) The economy's structural problems are reflected in its inability to generate or attract investment. Central Bank figures indicate that foreign direct investment inflows, which were a pathetic $562 million in 2002, fell to less than $400 million in 2003. Our discussions with the business community suggest that -- with the exception of some exporters -- local businesses are investing only enough to maintain existing capacity. Without a significant increase in foreign investment, it is hard to see how Turkey will achieve sustained 5-6 percent growth, particularly now that much of the slack capacity from the 2001 capacity has been brought back into use. Central Bank Governor Serdengecti argues that Turkey's ability to attract more foreign investment will determine whether it grows at 4 percent or 6 percent annually.

¶9. (C) Unfortunately, no one at the political level in this government understands the importance of structural reforms, so there is no champion (at least one with clout) for implementing those reforms. As a result, we can expect uneven and inconsistent reform implementation. As has long been the case, consistent international pressure -- i.e., effective use of economic policy conditionality by foreign official lenders -- is going to be key to achieving progress on the reform agenda. The IMF will no doubt continue its conditionality, but the Fund is focusing on a narrow, if important, range of issues, and its leverage is decreasing. We can expect the World Bank -- with which the GOT shows signs of re-engaging -- to condition its lending on implementation of structural reforms, but the Bank has always lacked real leverage here and will need our support.

¶10. (C) We can do our part by continuing to engage actively on behalf of the IMF and World Bank-supported programs, and by wisely using the economic conditionality in our Financial Agreement, if and when Turkey ratifies it. Specifically, we should press the GOT to proceed with important structural reforms, including privatization, support for independent regulators, and tangible steps toward development of energy and telecommunications markets. We also need to continue to press the GOT to eliminate WTO-inconsistent market access problems and to resolve the problems affecting U.S. investors, with a systemic approach whenever possible. Prime Minister Erdogan's upcoming visit to Washington presents a good opportunity to make these points, and to underscore Turkey's opportunity to highlight at the June Istanbul summit all the economic progress Turkey can achieve over the next six months.
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